



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **200904026**

Release Date: 1/23/09

Date: October 29, 2008

501.30-00

501.32-00

501.33-00

501.36-01

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

Dear

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Because you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

In accordance with Code section 6104(c), we will notify the appropriate State officials of our determination by sending them a copy of this final letter and the proposed adverse letter. You should contact your State officials if you have any questions about how this determination may affect your State responsibilities and requirements.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: April 23, 2008

501.30-00
501.32-00
501.33-00
501.36-01

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

X =

Y =

State A =

Dear

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code. Based on the information provided, we have concluded that you do not qualify for exemption under section 501(c)(3) of the Code. The basis for our conclusion is set forth below.

FACTS

You were formed in State A as a Not-for-Profit Corporation and have requested classification as a tax exempt, publicly supported organization under sections 501(c)(3) and 509(a) of the Internal Revenue Code.

Your articles of incorporation state that you are organized for charitable purposes. Your bylaws describe you as a "charitable business" organized "(1) To provide food, clothing, and educational supplies to pantries, churches, schools, and organizations that provide for the hungry and needy families and individuals, (2) Promote awareness within the city and enforce all State non-profit laws and regulations, (3) To cooperate and assist in the development of communities, (4) To promote all means of increasing the level of professionalism and efficiency of local food pantries, (5) To create a better public understanding and appreciation of the need for family support, and their importance to public health, safety and welfare, and (6) To promote the development of uniform administrative ordinances, inspection methods, and enforcement procedures." The narrative you submitted as part IV of your application describes your services as conducting a "community food bank" set up to "support the pantries, churches, and other organizations that support and provide food or clothes to the individual." While you refer to "supporting" other organizations, you have not stated whether this support will consist of giving away food and other items or whether you will sell the items. The only other activities you plan to conduct are various fundraisers.

You have not secured any property for use in your food bank activities, nor have you described any specific plans for doing so in the future. You have no agreements with the organizations you claim you will serve and have provided only a general description of how you will determine who to supply. You have no draft brochures, no letters and no website. You have not described how you will acquire commodities for the food bank. In addition, despite requests you have not provided any estimates of the amount or sources of your revenues.

In contrast to your description of your proposed exempt activities, you submitted detailed descriptions of plans for fundraising activities, including sponsoring golf tournaments and sending mailings. In addition, you plan to contract with three fundraising and management consultants in order to solicit financial support. You have not provided any descriptions of these consultants' activities or their compensation, other than to indicate that they will each be compensated more than \$50,000.

You have provided detailed lists of expenses including \$ in salaries and wages for your officers, attorneys, secretaries, accountants, and others; \$ for travel; \$ for "occupancy;" \$ for "supplies;" and \$ for conferences. In contrast, you have provided no information on the amount of money devoted to your program services. You categorized food distribution and purchase expenses as "miscellaneous" and stated "budget for food distribution not yet known."

You were incorporated by X and Y, who are husband and wife. Your Bylaws provide for four officers: President/CEO, Executive VP/COO, Secretary, and Treasurer. X serves as the President and CEO and is paid a salary of \$. Y serves as the Executive VP/COO and is paid a salary of \$. You state that your Secretary and Treasurer are "unknown at present" but that they will each be paid a salary of \$. In addition, you stated that the same person may hold any two or more offices.

Prior to creating your organization, X made deliveries and stocked shelves at a food bank. Y previously provided administrative services to a food bank. Neither X nor Y were compensated at previous food bank jobs they held. You have not provided any other information about their qualifications or education.

You indicated that your officers, X and Y, do not have a specific term and can serve until their resignation or removal. When asked how officers can be removed, you stated only that "[u]nless otherwise provided in the bylaws any officer or agent may be removed by irresponsible actions or resignation" and did not provide any information regarding who removes an officer or what procedures must be followed.

Your application contained a reference to a Board of Trustees, but your bylaws do not contain a description of the Board of Trustees, their powers, or how either Trustees or officers are selected and removed. When asked what the powers of Trustees were, you responded only that "[t]he management and affairs of the corporation shall be at all times under the direction of the Executive Officers and Trustees, whose operations in governing the corporation shall be defined by statute and by the corporation's by-laws."

LAW

Section 501(c)(3) of the Internal Revenue Code provides an exemption from taxation for organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(a)-1(c) of the regulations defines private shareholder or individual as a person having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. To meet the requirement of this subsection, the burden of proof is on the organization to show that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense and includes the relief of the poor and distressed or of the underprivileged as well as the advancement of education.

Section 1.501(c)(3)-1(e)(1) of the regulations provides that an organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purposes of carrying on an unrelated trade or business.

Rev. Rul. 69-383, 1969-2 C.B. 113, provides an example of a possible inurement situation that did not jeopardize an organization's exempt status. In the revenue ruling a tax exempt hospital entered into a contract with a radiologist which provided that the radiologist would be compensated by receiving a percentage of the gross receipts of the radiology department. The contract was negotiated on an arm's-length basis, the radiologist did not control the hospital, the amount received under the contract was reasonable in terms of the

responsibilities and duties assumed, and the amount received under the contract was not excessive when compared to the amounts received by other radiologists in comparable circumstances.

Rev. Rul. 72-369, 1972-2 C.B. 245, held that an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations did not qualify for exemption under section 501(c)(3) of the Code. Providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The fact that the services were provided at cost and solely for exempt organizations was not sufficient to characterize the activity as charitable for purposes of section 501(c)(3) of the Code. "Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable."

Rev. Proc. 2008-9, 2008-2 I.R.B. 258, provides that exempt status may be granted in advance of the organization's operations if the proposed activities are described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements for exemption pursuant to the section of the Code under which exemption is claimed. The organization must fully describe all of the activities in which it expects to engage, including the standards, criteria, procedures or other means adopted or planned for carrying out the activities, the anticipated sources of receipts, and the nature of contemplated expenditures. A mere restatement of exempt purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy this requirement.

In Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

In Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953), the court acknowledged that payment of reasonable compensation to officers is not inurement. The court went on to say, however, that if the salaries paid are excessive and unreasonable then inurement of corporate net income will result. Such inurement would not allow an organization to claim tax exemption.

In American Institute for Economic Research v. United States, 302 F. 2d 934 (Ct. Cl. 1962), the court considered an organization that provided analyses of securities and industries and of the economic climate in general. It sold subscriptions to various periodicals and also services providing advice for purchases of individual securities. The court noted that education is a broad concept, and assumed *arguendo* that the organization had an educational purpose. However, it held that it had a significant non-exempt commercial purpose that was not incidental to the educational purpose, and therefore was not entitled to be regarded as exempt.

In Bubbling Well Church of Universal Love, Inc. v. Commissioner of Internal Revenue, 74 T.C. 531 (1980), the court considered an adverse ruling by the Internal Revenue Service on an application for exempt status as a church. The court noted that the only voting members and directors of the organization were a husband and wife and their son, who had no affiliation with any denomination or ecclesiastical body or other outside influence. The applicant had declined to furnish some information, and made answers to other inquiries that were vague and

uninformative. On the basis of the record, the court held that the applicant had not shown that no part of its net earnings inure to the benefit of the family or that petitioner was not operated for the private benefit of the family.

In People of God Community v. Commissioner of Internal Revenue, 75 T.C. 127 (1980), the court found that part of an organization's net earnings inured to the benefit of private individuals because their compensation was based on a percentage of the organization's gross receipts with no upper limit. The court held that the petitioner was not exempt as an organization described in section 501(c)(3) of the Internal Revenue Code of 1954. The court stated that the burden falls upon the petitioner to establish the reasonableness of compensation paid to private individuals.

In Church of Scientology v. Commissioner of Internal Revenue, 823 F. 2d 1310 (9th Cir. 1987), the court upheld the Commissioner's revocation of exempt status and assessment of tax deficiencies because the organization allowed its assets to inure to the founder and his family. The founder had unrestrained and unaccounted for access to some Church funds, and the Church failed to prove that the funds were spent on behalf of the Church.

In Miller & Sons Drywall, Inc. v. Commissioner of Internal Revenue, T.C. Memo 2005-114, the court set out several factors that should be considered when determining whether compensation is reasonable. These include the employee's qualifications, the nature, extent, and scope of the employee's work, the size and complexity of the business, prevailing general economic conditions, the employee's compensation as a percentage of gross and net income, the employee's compensation paid in prior years, and prevailing rates of compensation for comparable positions in comparable concerns.

New Dynamics Foundation v. United States, 70 Fed.Cl. 782 (2006), was an action for declaratory judgment that the petitioner brought to challenge the denial of his application for exempt status. The court found that the actual purposes displayed in the administrative record supported the conclusion of the IRS. If the petitioner had evidence that contradicted these findings, it should have submitted it as part of the administrative process. "It is well-accepted that, in initial qualification cases such as this, gaps in the administrative record are resolved against the applicant."

ANALYSIS

Exemption from federal income taxation is not a right, it is a matter of legislative grace that is strictly construed. New Dynamics, *supra*. The burden is on the applicant to prove that it is entitled to exempt status. *Id.* An applicant must prove that it is organized and operated exclusively for exempt purposes and not for the private benefit of its creators, designated individuals or organizations controlled by such private interests. Treas. Reg. 1.501(c)(3)-1(d)(1)(ii). Exclusively does not mean "solely," but no more than an insubstantial part of an organization's activities may further a non-exempt purpose. Better Business Bureau, *supra*.

An applicant for exempt status must provide sufficient information for the Service to make an informed decision. The application must include details, figures, and documentation. Basic Bible Church, *supra*. Exempt status may be granted in advance of an organization's

operations, but its activities must be described in sufficient detail to permit a conclusion that the organization will clearly meet the requirements for exemption. Rev. Proc. 2008-9, supra. Based on the information submitted, you have failed to establish that you will conduct any activities in furtherance of an exempt purpose, that no part of your net earnings will inure to private individuals and that you will be operated for a public rather than a private interest.

No Activities in Furtherance of an Exempt Purpose

In order to qualify for tax exemption, an organization must show that it is operated exclusively for exempt purposes. See Section 1.501(c)(3)-1(c)(1). You were established for the charitable purpose of providing food and other items for the needy. The only activities you plan to conduct are distributions of food and clothing to food banks, churches, and similar organizations. While donating these items to other organizations might further a charitable exempt purpose, merely providing commercial services, such as sales of items, to exempt organizations does not. Rev. Rul. 72-369, supra. Such activities are merely commercial activities. An organization is not eligible for exemption if it operates for a substantial commercial purpose. American Institute for Economic Research, supra. In your application you did not indicate whether you will sell the food and clothing or whether you will exclusively donate it. Gaps in an application are resolved against the applicant. New Dynamics, supra. You have not demonstrated that your distribution activities will consist only of donations to organizations or individuals, therefore we cannot conclude that your activities do not substantially further a commercial, non-exempt purpose.

Even if you plan to donate items and not sell them, you have not demonstrated that you will actually conduct those activities. You have not secured any real or personal property for use in your activities, nor have you described how you plan to do so. The financial information you provided gives detailed accounting of expenses such as \$ for travel and \$ for conferences, yet under "food distributed" in your expense sheet, you state "[b]udget for food distribution not yet known." You have not provided sufficient information for us to conclude that you will conduct any distributions of food or other items. Therefore, you have not demonstrated that you are engaged in any activities that further an exempt purpose.

Private Inurement

An organization will be denied exemption if any of its net earnings inure to the benefit of private individuals. Treas. Reg. § 1.501(c)(3)-1(c)(2). Even a small amount of inurement will prevent a grant of exemption. X and Y are the incorporators of your organization, they are its Executive Officers, and they have control over the operations of your organization. They have a personal interest in your activities. Thus, X and Y are both private individuals within the meaning of section 1.501(a)-1(c) of the regulations.

If an organization pays unreasonable compensation to private individuals, this will constitute inurement. Mabee Petroleum Corp. v. United States. In order to determine when compensation is unreasonable, several factors may be considered. These include an employee's qualifications, the nature, extent, and scope of the employee's work, the size and complexity of the business, prevailing general economic conditions, the employee's compensation as a percentage of gross and net income, the employee's compensation paid in

prior years, and prevailing rates of compensation for comparable positions in comparable concerns. Miller & Sons Drywall, Inc. v. Commissioner of Internal Revenue.

X held 2 previous food bank jobs. His duties included driving vehicles, making deliveries and stocking shelves. X was not compensated at either of these positions. You have not provided any information on X's level of education or other qualifications. Despite this, you intend to pay X a salary of \$. The only qualifications you have provided for Y are her previous experiences assigning menu options, stocking shelves, and other administrative duties. You intend to pay Y a salary of \$. In addition, your bylaws allow individuals to hold 2 or more officer positions. It is possible that X and Y will also hold the Secretary and Treasurer offices, adding \$ to their compensation.

You provided salaries of just two other organizations in your application. They do not reflect similarly situated organizations and therefore cannot be used to substantiate the salaries paid by your organization. You provided salary information from an organization with \$54 million in revenues and for an organization with \$640 million in revenues. However, you have not had any revenues in the past and have not established that you will have any significant revenues in the future, despite requests for such information. Your organization is not currently operating and is neither large nor complex.

In addition, you have not presented any facts similar to those of Rev. Rul. 69-383. X and Y control your organization and you have not shown that the salaries for X and Y were negotiated on an arm's length basis.

Based upon these facts, you have not demonstrated that the compensation paid to X and Y is reasonable, therefore you have not established that no part of the net earnings of your organization inure to the benefit of private individuals. As a result, you do not meet the requirements for tax exemption.

Private Benefit

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization cannot qualify for exemption if it is operated for private rather than public purposes. In addition, the regulation provides that the organization must demonstrate that it is not operated for the benefit of private individuals, such as its creator and his family.

X and Y control your organization through their positions as officers. You state that your organization is governed in part by a Board of Trustees, yet despite requests you have provided no information about how this group takes action or whether their actions can be overruled by X and Y. Furthermore, you indicated that you will hire consultants and compensate them with significant amounts of money yet you have not described their activities or how you will ensure that such amounts are reasonable. These factors indicate that your organization will be operated for the benefit of private individuals. See National Association of American Churches, supra; Bubbling Well Church of Universal Love, supra; Church of Scientology, supra.

Based upon the facts presented, you have not established that your organization will not be operated for the benefit of X, Y, and your consultants. Therefore, you have not met your burden to prove that you will be operated for public rather than private purposes. Consequently,

you are not eligible for exemption under section 501(c)(3) of the Code even if you did conduct activities in furtherance of an exempt purpose.

Conclusion

You have not established that you will be conducting any activities in furtherance of an exempt purpose described in section 501(c)(3) of the Code. You have not established that you are not operated primarily for non-exempt commercial purposes. Nor have you demonstrated that no part of your net profits will inure to the benefit of private individuals. Finally, you have not established that you will operated for public instead of private purposes.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to protest as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service

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1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements